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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON THE INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING AND REPORTING, ISSUES IDENTIFIED DURING THE SEVENTH SESSION

Accounting for and by joint ventures

Report of the Secretary-General

SUMMARY

Because of the increasing use of joint venture arrangements as a vehicle of investment, it is necessary to harmonize practices used in accounting by and for joint ventures. Accounting by joint ventures should follow internationally accepted practices. Accounting for joint venturers should emphasize substance over form. Whatever their legal form, joint ventures involve a contractual arrangement whereby two or more ventures undertake a specific economic activity over which they have equal control. Three types of joint ventures can be identified: jointly controlled entities; jointly controlled operations; and jointly controlled assets. Accounting for jointly controlled operations and assets involves no controversy because joint ventures of these types are not separate entities. Accounting for jointly controlled entities can best be done using the proportionate consolidation method which emphasizes the substance rather than the legal form. When the venturer uses proportionate consolidation, its consolidated balance sheet reflects its share of the assets it controls jointly, its share of the liabilities for which it is jointly responsible, and its consolidated income statement reflects its share of the operating activities of the jointly controlled entity.

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INTRODUCTION

1. In its traditional form, a joint venture is a co-operative arrangement between two or more parties (venturers) for the purpose of carrying out a single project which was usually dissolved upon completion of the project. Joint ventures existed in medieval Italy for financing international commercial voyages. Historical evidence can be found of the profit calculations for such ventures by two Genoese merchants in 1156-1158. 1/ In the sixteenth and seventeenth centuries in England, joint ventures for the sale or exchange of a cargo of merchandise in a foreign country were common. Accounting for these joint ventures was not on an accrual basis, since the net income was not recognized until the voyage was completed. At the end of the voyage, the venturers divided the net realized income among themselves.

2. Joint ventures, in the sense in which the term is generally used in business today, are largely a development of the period since the Second World War. Ordinarily, a joint venture denotes a strategic alliance whereby two or more parties combine their resources and skills in an economic activity with the objective of receiving benefits from it. The participants in a joint venture are generally referred to as parties, venturers, or partners. The joint venture can be a national or an international one, the later being present if the participants come from different countries. Joint ventures have long been used in international business for expansion into markets, particularly in developing countries. In recent years, joint ventures are being used as the principal vehicle for foreign direct investment in centrally planned economies. However, in developed market economies, as business risks soared and competition grew fiercely, firms have embraced both national and international joint ventures with increasing frequency.

3. The characteristic features of joint ventures give rise to some very important accounting issues which need to be addressed by accounting standard setters. There are two sides of these accounting issues. One is accounting and financial reporting by the joint venture, and the other is accounting and financial reporting for joint venture investments by the venturers. The former becomes most acute when venturers come from different accounting environments.

4. This report analyses the issues relating to accounting for and by joint ventures. The central objective of the analysis is to provide direction to the accounting policy makers regarding standards for joint venture accounting. The report is divided into five parts: chapter I deals with definitions and types of joint ventures; chapter II addresses the issues relating to accounting by joint ventures; chapter III focuses on accounting issues and problems in international joint ventures; chapter IV examines the various approaches of accounting for joint venture investments; and chapter V draws conclusions from the body of the report.

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I. DEFINITIONS

5. The term "joint venture" has different meanings in different parts of the world. Common elements include:

(a) Two or more parties;

(b) A contractual agreement;

(c) Joint control (i.e., no party can unilaterally control the financial and operating policies of the venture).

A review of the joint venture arrangements in different countries reveals that many joint ventures have some or all of the following characteristics:

(a) The life of a joint venture is limited to that of the business undertaking, which may be of short or long-term duration depending on the circumstances;

(b) The joint activities are similar or ancillary to the other activities of some or all of the venturers;

(c) The venturers contribute resources in addition to or other than cash, such as other current assets, long-term assets, technical know-how or human resources;

(d) The venturers have the right to take a share of the output from the joint venture.

6. From the perspective of the common elements listed above and characteristics of joint ventures in different parts of the world, a joint venture may be defined as an arrangement whereby two or more venturers (parties) enter into a contractual agreement to jointly control a specific business undertaking and contribute resources to accomplish agreed-upon goals. The business undertaking may be a single project or a business enterprise.

7. A joint venture implies that control is shared, with no one of the venturers in a position to exercise unilateral control of the venture. The joint control of the participating venturers derives from the written legal agreement. Control does not necessarily have to be related to the proportion of contributed capital by each venturer. In practice, one venturer may contribute the majority part of equity capital but willing to share equal control because the other venturer contributes technological know-how and/or management and marketing expertise. Also, in mining and oil exploration activities, one party may be willing to pay a majority of the exploration costs for a majority portion of any forthcoming benefits, but control may still be shared. This element of joint control distinguishes a joint venture from other forms of long-term investment where control of decisions is related to the proportion of voting interest held.

8. The legal form chosen for a particular joint venture arrangement results from consideration of the relationship desired by the participating venturers within

parameters set by taxation, contract and partnership/company (corporation) law. Income tax considerations can be particularly important. Considering the legal (including taxation) ramifications of the formation of the joint ventures, the ventures often choose one of the following forms of business organization:

(a) Partnership of the participating venturers;

(b) Separate company (corporation) formed for the purpose of the joint venture;

(c) Undivided interests in the joint venture activities managed either by the outside managers or by a designated venturer acting as an agent on behalf of the participating venturers.

9. Regardless of the legal form of a joint venture, for accounting purposes joint ventures can be described as belonging to one of the following three types:

(a) Jointly controlled entities;

(b) Jointly controlled operations;

(c) Jointly controlled assets.

The International Accounting Standards Committee (IASC), in its exposure draft (E 35), on "Financial reporting of interests in joint ventures", (1 December 1989) identified the above-named three types of joint ventures. The United States Financial Accounting Standards Board (FASB), in a meeting in 1987, accepted staff recommendations to identify joint ventures as follows: investments in jointly controlled entities, and participation in joint operations. The FASB views types (b) and (c) above as belonging to one group. The FASB recognizes that the accounting procedures for jointly controlled entities should differ from those for participation in joint operations. Since the type of joint venture has important accounting implications, it seems prudent to identify three types of joint ventures. The descriptions of the three types presented below clearly distinguish one from another.

A. Jointly controlled entities

10. Jointly controlled entities are separate legal entities. These may be corporations, partnerships or any other forms of organization. Each of the participating venturers has an interest in the jointly controlled entity, which is normally managed by hired managers. The entity, in its name, owns the assets of the joint venture, incurs liabilities and expenses, and earns revenues. Being a legal person in the eyes of law, the jointly controlled entity has the right to enter into contracts in its own name and raise finance for the purpose of the joint venture. Each venturer is entitled to a share of the profits earned by the jointly controlled entity. The distribution of profits is made in accordance with the proportions specified in the joint venture agreement. It is worth mentioning here that, in some cases, a portion of the equity capital of the joint venture

enterprise may be subscribed by individuals or organizations that do not share in the control of the enterprise. However, the entity is jointly controlled by two or more other venturers. The non-controlling share subscribers hold an investment in the joint venture which is similar in substance to any other investment in another entity.

B. Jointly controlled operations

11. In these operations no separate entity is formed. Instead, parts of the venturers' existing enterprises work on a common project and co-ordinate their activities. The organizational structure remains flexible. In some cases joint "project teams" are formed, in others responsibilities are delegated as and when the need arises. The distinctive feature of this type of joint venture is that the assets and expertise assigned by each venturer for the joint venture activity remain under the ownership and control of the venturer who assigns them. The participating venturers perform their respective parts of the joint venture activity using their own resources. The benefits are shared by the venturers on an agreed basis. Examples of jointly controlled operations include those joint venture arrangements under which the venturers jointly produce, market and distribute a particular product, such as an aircraft, using each venturer's resources such as its property, plant and equipment, technical expertise and employees.

C. Jointly controlled assets

12. Although jointly controlled assets are not separate entities, the resources contributed by the participating venturers are pooled together for the purpose of a joint venture project which is managed either by one managing venturer or by a joint management team, typically known as the operator. The joint venture agreement defines the responsibilities and obligations of the operator, the interests of the parties etc. The distinctive feature of a joint venture of this type is that its assets are jointly owned or controlled by all the venturers. Each venturer possesses an undivided interest in the assets. The costs of running the project are shared by the participating venturers on an agreed basis; each venturer usually takes a portion of the output of the joint venture. This type of joint venture arrangement is prevalent in the oil, gas and mineral extraction industries. An example of jointly controlled assets is the case where two or more oil exploration companies enter into a joint venture agreement to own and operate jointly an oil pipeline.

13. One interesting aspect of joint venture arrangements is that, in many cases, what started as jointly controlled assets are transformed at a later stage into a jointly controlled entity. Furthermore, in some cases, the same joint venture arrangement combines different types of joint venture activities - for example, when the production is carried out through a jointly controlled operation, or when marketing and after-sales servicing of the product is performed by a jointly controlled entity. Because of the diversities in structure or form of joint venture arrangements, it is necessary for accounting and financial reporting for investments in joint ventures to reflect substance over form.

II. ACCOUNTING BY JOINT VENTURES

14. The accounting and financial reporting by a joint venture depends on its form - i.e., accounting by the three types of joint ventures described above needs to be carried out in three different ways. The basic accounting principles applied in all types of joint ventures, however, are the same. Many joint venture enterprises develop their own accounting system within the framework of generally accepted accounting principles of the country of operation. Although different countries have different accounting standards, in the case of international joint ventures it is necessary for the accounting practices of the joint ventures to conform to the internationally acceptable accounting principles. Below the accounting procedures in the case of each of the three types of joint ventures are described.

A. Accounting by joint ventures in the case of jointly controlled entities

15. The formation of a jointly controlled entity is a transaction in which the ownership interest in the venture is exchanged for whatever consideration is received from the participating venturers. If all the venturers provide cash for ownership interest in the joint venture, the accounting for preparation of the opening balance sheet of this enterprise is fairly simple. If the venturers contribute only non-monetary assets (assets other than cash) or cash plus some non-monetary assets, the fair market value of each non-monetary asset needs to be estimated. An independent appraisal of the non-monetary assets may be required in cases where their values are not apparent from other sources. After preparation of the opening balance sheet of the jointly controlled entity, normal accounting in accordance with the generally accepted accounting principles is applied to the future transactions.

16. The legal form of a jointly controlled entity determines the procedure of financial reporting by the joint venture. If it is an unincorporated entity, the financial reporting procedure of the entity should be similar to the financial reporting of a business partnership. Accordingly, the financial statements of an unincorporated jointly controlled entity should include a "Statement of venturers' capital" showing each venturer's capital account balance at the beginning of the accounting year, plus the venturer's share of the net income for the year, plus (if any) new capital contribution by the venturer during the year, and minus any withdrawal by the venturer during the year. The ending balance of each venturer's capital account shown in the statement of venturers' capital should be reported against each venturer's name in the "venturer's capital section" of the balance sheet.

17. If the jointly controlled entity is an incorporated one - i.e., a corporation - its financial reporting and accounting disclosures should follow the conventional or legal requirements on corporate accounting in the country of operation. At a minimum, the jointly controlled corporate entity needs to prepare its financial statements in accordance with the procedure laid down in Conclusions on Accounting and Reporting by Transnational Corporations prepared by the

Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR). 2/

B. Accounting by joint ventures in the case of jointly controlled operations

18. The joint venture activities of a jointly controlled operation are delegated to the participating venturers, and each venturer carries out its part of the activities using its own resources. In this type of joint venture, no separate joint accounts of the jointly controlled operations are prepared. Therefore, the question of accounting by joint ventures does not arise. Each venturer maintains accounting records for its part of a jointly controlled operation, which will be discussed in part IV covering accounting for joint ventures.

C. Accounting by joint ventures in the case of jointly controlled assets

19. These joint ventures normally maintain separate accounting records of the expenses incurred for the jointly controlled assets, and the resources received from and the outputs delivered to the joint venture participants. These accounting records are maintained by the operator of the jointly controlled assets. The joint venture agreement includes an accounting agreement. The main provisions of the accounting agreement encompass the approval, funding, reporting, allocation, charging and audit of expenditures applicable to the joint venture.

20. Generally, the operator is given authority to commit and incur expenditures by virtue of an approved AFE (authority for expenditure) within the agreed work programme and budget. An AFE covers a particular activity. In a joint venture for oil exploration, for example, it may cover an exploration well or the construction of part of the production facilities. The AFE is normally broken down and reported against controllable cost categories. As a result, a measure of control is exerted by the venturers (non-operators), while allowing the operator the flexibility to perform the task. Any revisions to the work programme and budget are to be approved by the venturers periodically.

21. During the various stages of joint venture activity, the operator will receive cash and non-cash resources from the participating venturers. The operator will make cash calls on the venturers and will deposit the funds into bank accounts under joint names of the venturers. The operator will have the authority to operate these joint bank accounts. Disbursements will be made by the operator from these bank accounts. If the operator is one of the venturers, financial operations of the jointly controlled assets must be segregated from its financial operations of other areas of involvement.

22. The accounting agreement for a joint venture involving jointly controlled assets lays down procedures for reporting back to the venturers, on a monthly basis, expenditures, commitments, estimated total expenditures against budget, cash balances, accruals etc. This information needs to be in sufficient detail for

venturers to review the current management, and also for them to use information as appropriate in their own financial statements.

23. The accounting agreement also specifies how the various costs are to be allocated between the participating venturers. In accordance with the agreement, at regular intervals, the operator sends bills to the individual venturers for their respective shares of the total joint venture costs. The simplest form of allocation is where each partner has a fixed equity interest. After the inception of the joint venture, the percentage interests of the venturers may change. The cost allocation is adjusted to reflect these circumstances.

24. Another level of allocation is accounting for the income or tariff derived from joint venture activity for the use of its assets by enterprises other than the joint venture participants. For example, an outside oil exploration company may wish to use the oil pipeline system of a joint venture for a tariff based on each barrel of throughput. The arrangement may suit the pipeline owners because the production from their own fields may be insufficient. With the high investment in oil pipelines, a great deal of thought, effort and negotiation is required to effect an arrangement between the pipeline owners and the outsider; these arrangements are now becoming more commonplace. Procedures for allocating these revenues to the participating venturers of jointly controlled assets need to be agreed upon by all the venturers.

25. If the operator is one of the venturers and some of its own resources are used for joint venture activity, there may be some problems in charging expenditures to the joint venture. There is no problem with direct expenditures, so long as the operator's accounting system can clearly identify the costs arising from a particular joint venture. Problems may arise over the amount to be charged to the joint venture for the services of facilities and staff of a large operator involved in many activities. There is no fixed method for charging expenditures. It is up to the participating venturers to come to an equitable arrangement. However, an underlying principle in a cost sharing arrangement should be that the operator neither loses nor gains by virtue of acting in that capacity.

26. No accounting agreement for jointly controlled assets is complete without provisions for an audit. The participating venturers must be afforded the facility to review and check in detail the information substantiating the expenditure reports submitted by the operator. Instead of performing individual audits, it is the usual practice for the participants to provide members for a joint audit team to visit the operator's premises. Any points of dispute regarding allocation of costs to the venturers, charging of expenditures to the joint venture, cash balances etc. are normally resolved without resort to the arbitration clause of the joint venture agreement.

III. ACCOUNTING ISSUES AND PROBLEMS IN INTERNATIONAL JOINT VENTURES

27. When venturers from different countries form a joint venture, it takes on the character of an international joint venture. Often venturers from developed market economies form joint ventures with public or private sector enterprises in

developing countries and in centrally planned economies. Moreover, international joint ventures within developed market economies are quite commonplace. Normally international joint ventures are jointly controlled entities. In an international joint venture, especially in a developing country or in a centrally planned economy, a Western venturer often encounters, among others, accounting problems arising mainly from the accounting environment in the host country. The accounting environment is influenced by the existence of generally accepted accounting principles, auditing practices and the competent accountants.

28. Many developing countries do not have an institutional framework for setting accounting standards. Consequently, diverse accounting practices are prevalent in these countries. Under such circumstances in developing countries, a Western venturer may install a Western accounting system in the international joint venture. This may, however, give rise to some problems from the perspective of the host-country venturer(s) and public policy makers. This is because the accounting objectives in the host country and in the Western venturer's home country may be different. This problem may not be completely overcome until harmonization of national accounting practices is achieved. However, many of the problems created by national differences in accounting practices may be diminished if international joint ventures, at the minimum level, considered ISAR's Conclusions on Accounting and Reporting by Transnational Corporations. 2/

29. When a Western venturer forms an international joint venture with its counterpart in a centrally planned economy, some acute accounting problems may arise. Traditionally, the objective of accounting in a centrally planned economy is to provide information for national planning and public policy-making. By contrast, Western accounting systems provide information for decision-making by various external interested parties including investors, creditors, customers, suppliers and public-interest groups as well as home and host Governments. When the Government of the centrally planned economy requires joint ventures to follow the same accounting regulations applicable to domestic State-owned enterprises, the Western venturers encounter various problems. This is mainly because the concepts of assets, liabilities, revenues and expenses as applied to state-owned enterprises in a centrally planned economy differ from those in the West. Because of these differences, the operating results and the financial position of a joint venture in a centrally planned economy may be different from what they would have been according to the generally accepted accounting principles in the West. Consequently, from the perspective of a Western venturer's home-country accounting and financial reporting, some serious accounting problems may arise in the reconciliation of accounts.

IV. ACCOUNTING FOR JOINT VENTURES

30. When accounting and reporting for interests in joint ventures, it is essential that each venturer reflect the substance of the joint venture arrangement, whatever its structure or form. The procedures of accounting for the three types of joint ventures are discussed below.

A. Accounting for jointly controlled entities

31. The basic issue in accounting for investments in jointly controlled entities relates to the choice of method of reporting the investments in the financial statements of participating venturers. The choice of method determines the amounts reported for the investment in the balance sheet and the manner in which operating results from the investment is reported in the income statement. It is worth mentioning here that the legal form of a jointly controlled entity should not govern the choice of method. For tax and various other considerations a jointly controlled entity may be either incorporated or unincorporated, but the substance of the joint venture arrangement will be same. Therefore, the methods discussed below are applicable to both incorporated and unincorporated forms of jointly controlled entities.

32. Available accounting literature on consolidation, investments and joint ventures lead to consideration of the following possible methods of accounting for investments in jointly controlled entities:

(a) Full consolidation method;

(b) Equity method;

(c) Proportionate consolidation method;

(d) Expanded equity method;

(e) Cost method;

(f) Fair market value method.

1. Full consolidation method

33. The full consolidation method which is ordinarily referred to as consolidation, is appropriate under the circumstances where the investor owns the majority of voting stock (more than 50 per cent) of the investee. The investee is the entity in which investment has been made. In this case the investor holds majority controlling interest and it has the ability to control unilaterally the financial and operating policies of the investee.

34. Under the consolidation method, the specific assets and liabilities of the investee are included in the balance sheet of the investor, and the specific revenues and expenses of the investee are included in the investor's income statement. Thus the consolidated financial statements of the investor is prepared. That portion of the investee's net assets (assets minus liabilities) and earnings allocable to other investors is shown in the consolidated financial statements as minority interest (a quasi-liability in the balance sheet, and a quasi-expense in the income statement).

35. The principal advantage attributed to the full consolidation method is that it reflects the full scope of operations and financial position as an integral part of the investor's financial statements, with outside interest treated as a minority. The principal disadvantage of this method is that it shows assets and operations that are not under the control of the investor as if they were.

36. The full consolidation method meets the requirements of generally accepted accounting principles when one of the investors is in control. The control aspect of a joint venture arrangement, however, makes full consolidation inappropriate for reporting investments in jointly controlled entities. As mentioned above, the joint venture agreement of a jointly controlled entity precludes unilateral control by any of the venturers. According to the definition of a joint venture, majority ownership interest of any one venturer does not necessarily establish majority control of that venturer. Therefore, the use of full consolidation in accounting for jointly controlled entities seems inappropriate.

2. Equity method

37. The equity method is used when the investor has the ability to exercise "significant influence" over the investee. A "significant influence" is normally presumed to exist when the investor has 20 per cent or more ownership interest in the investee. The main principle of the equity method is that the initial investment is recorded at cost and reported as a one-line item in the balance sheet of the investor. This is why this method is sometimes called one-line consolidation. The investment is increased (decreased) by the investor's proportionate share of profit (loss) declared by the investee. When a dividend is received by the investor, the investment amount is reduced by the amount of dividend received. At the time of preparing the investor's financial statements, if any difference is observed between the carrying value of the investment and investor's proportionate share of the net assets reported in the financial statements of the investee, such a difference should be amortized.

38. Some of the disadvantages attributed to the equity method in the case of accounting for investments in jointly controlled entities are:

(a) It tends to obscure the nature and volume of the business of a venturer that conducts significant operations through jointly controlled entities;

(b) It excludes from the venturer's financial statements assets and liabilities essential to the conduct of the venturer's business operations through jointly controlled entities;

(c) It excludes from the income statement elements of revenue and expenses arising from the operations of the jointly controlled entity, that may be a significant aspect of the venturer's operations;

(d) It is not informative about the economic effect of the venturer's investment in and commitment to jointly controlled entities with thin equity and heavy debt financing.

39. Because of the increasing use of jointly controlled entities to conduct business activities that are an integral part of the operations of the participating venturers, as well as their potential for off-balance-sheet financing, the equity method does not seem to reflect the economic realities of joint venture arrangements. An appropriate method of accounting for investments in jointly controlled entities is necessary, one that provides more useful information about the operations, the financial resources of the venturer and the risks to which it is subject.

3. Proportionate consolidation method

40. Under the proportionate consolidation method, an investor consolidates, in its financial statements, its proportionate share of each asset, liability, revenue, and expense item of an investee. Some of the advantages attributed to the proportionate consolidation method of reporting investments in jointly controlled entities are:

(a) It provides information in a venturer's financial statements on past and prospective changes in the economic resources and obligations of a venturer which is useful to present and potential stockholders and creditors;

(b) It reflects significant economic relationships between the venturer and the jointly controlled entity, such as complementary or integrated operations and obligations through direct or indirect guarantee or support agreement;

(c) It recognizes that a part of the assets, liabilities and operations of a joint venture enterprise is under control of a venturer. (Joint control is the most important characteristic of a joint venture arrangement.)

41. The proportionate consolidation method clearly reflects the substantive difference between an investor's involvement with joint ventures and other investees. Since a joint venture agreement establishes joint control of the participating venturers, proportionate consolidation of a jointly controlled entity's accounts in a venturer's financial statements would merely be an extension of the practice of including the accounts of all controlled entities, with related as well as unrelated lines of business, in the venturer's consolidated financial statements. The use of the proportionate consolidation method would result in consistent accounting for all business activities in which a venturer is directly involved, regardless of the form of organization used to conduct such activities.

42. Proportionate consolidation may be more appropriate for an enterprise that carries out most of its activities via joint ventures than for an enterprise for which this mode of operation is the exception. Objections have been raised concerning the use of proportionate consolidation, such as that it gives users the erroneous view that the assets and operations are under the direct control of investors and that it reflects a portion of the liabilities of the venture as direct liabilities of the investor though no direct or indirect liability may exist for any of the venture's liabilities. Perhaps the strongest objection arises because the deep-seated belief of some experts that the control exercised by the

partners is somehow so imperfect that they have no control. They argue that proportionate consolidation is based on the concept of control of pieces of an entity, though no such control exists, and combines assets in the balance sheet and operations in the income statement which the investor directly owns and controls with pieces of assets and pieces of operations over which the investor has no control.

43. To avoid this very situation, the present report started with a clear description of a joint venture as an arrangement in which no party can unilaterally control the financial and operating policies. Therefore, decisions must be joint, and the case of a partner having no control is impossible.

4. Expanded equity method

44. Under the expanded equity method, an investor presents its proportionate share of the assets, liabilities, revenues and expenses of the investee in its financial statements, but with separate disclosure and without combining these amounts directly with its "own" assets, liabilities, revenues and expenses. Although this method has all the attributes of proportionate consolidation, it tends to convey to the users of financial statements that a venturer's proportionate share of assets, liabilities and operations in a jointly controlled entity lacks its direct control. In other words, the expanded equity method does not seem to recognize the fact that a venturer's ownership interest in a jointly controlled entity is as much in its control as it would have been in the case of a parent/subsidiary relationship.

45. Considering the nature of joint venture arrangements, the concept of "direct control" may not be appropriate, as it would appear to emphasize the form rather than the substance of the jointly controlled entities. Moreover, in the case of a parent/subsidiary relationship, all assets included in consolidated financial statements are not always readily available to the parent company for general corporate purposes, and therefore, in a real sense they are not under the direct control of the parent. Still it is a well-established practice to consolidate a subsidiary's assets, liabilities and operations by reporting them along with similar items from a parent company's own financial statements. The proportionate consolidation method merely represents an extension of the current accounting practice on consolidation. Under the proportionate consolidation method, the consolidation is made on a proportionate basis because of the fact that no venturer can unilaterally control the entire operations of a jointly controlled entity. The expanded equity method, by differentiating between financial statement items, according to "direct control" and "indirect control" of a venturer, simply complicates the presentations in financial statements, and emphasizes form over substance.

5. Cost method

46. Under the cost method, an investor records its investment at cost, and reports the investment as a single-line on its balance sheet. Profits earned by the investee are not recognized in investor's accounts until such profits are distributed as dividends. The investment account continues to be carried in the balance sheet at the initial cost of the investment. When dividend is distributed

by the investee, the investor recognizes its share of the dividend as current income. Dividends received in excess of investor's share of earnings subsequent to the date of investment are considered a return on investment and are recorded as reductions of the cost of the investment. Compared to the equity method, one major shortcoming of the cost method is that it is not consistent with the accrual concept of accounting and it does not report earnings and losses on a timely basis.

47. The cost method of accounting for an investment in another entity is normally used in circumstances where the investor neither controls nor has the ability to exercise significant influence over the investee. Considering the fact that venturers' joint control is the most fundamental characteristic of a joint venture arrangement, the use of cost method in accounting for investments in jointly controlled entities seems inappropriate. However, there may be circumstances in which a venturer may not be in a position to exercise its rightful control over an international joint venture because of political instability or severe and prolonged foreign exchange restrictions in the host country. Also, for various reasons, there may be uncertainty about the safety of the assets invested in a host country. Under such circumstances, the cost method may be used under the accounting convention of "conservatism".

6. Fair market value method

48. A possible solution advocated by some is to report investments in joint ventures at their fair market value. The claimed advantage is that reporting the fair market value of the investments and changes in the fair market value would provide information about the attribute of the investment that is most relevant to the investor and to the users of the investor's financial statements. Some of the disadvantages attributed to the method are that determining the fair market value of the investments would be a difficult and highly subjective process and that reporting on that basis is outside the historical cost framework of conventional accounting practices.

7. Separate financial statements

49. In many countries, in order to meet legal or other requirements, a venturer may need to present separate financial statements in addition to consolidated financial statements. In its separate financial statements, a venturer may account for its interest in a jointly controlled entity either using proportionate consolidation or by using the equity method. Generally, venturers that use proportionate consolidation in consolidated financial statements use the equity method in their separate financial statements. In certain cases, a venturer may not need to issue consolidated financial statements, because it does not have subsidiaries or because it is itself a wholly owned or virtually wholly owned subsidiary. Under such circumstances, in preparing a venturer's separate financial statements, it is preferable to use proportionate consolidation to report the venturer's interest in a jointly controlled entity.

50. From time to time, a venturer may sell assets to or purchase from a jointly controlled entity. The accounting issue raised in these situations is the extent to which profits and losses on such transactions between the venturer and the joint venture should be recognized by the venturer. When a venturer sells assets to the joint venture, it recognizes any profits only to the extent that they relate to the interests of other venturers or when the joint venture sells the assets to an independent third party. A venturer recognizes losses resulting from sale of assets to the joint venture in the same way as profits, except that they are recognized immediately when they represent a permanent decline in the carrying amount of assets. When a venturer purchases assets from the joint venture, it recognizes its share of the profits of the joint venture only when it sells the assets to an independent third party. A venturer recognizes losses resulting from purchase of assets from the joint venture in the same way as profits except that they are recognized immediately when they represent a permanent decline in the carrying amount of assets.

8. Disclosure requirements

51. In order for the users of financial statements to obtain a clear understanding of its affairs, a venturer needs to make adequate disclosures in its financial statements regarding its interests in joint venture enterprises. In addition to the application of proportionate consolidation for interests in jointly controlled entities, a venturer should make separate disclosures in the notes of financial statements showing the extent of its involvements in the assets, liabilities and operations of jointly controlled entities. The disclosures that should be considered relative to jointly controlled entities are as follows:

(a) Accounting policies of the venturer with respect to the investments in jointly controlled entities;

(b) Name of the joint venture and percentage of ownership interest of the venturer. Normally, the name of the joint venture and the percentage owned would be given only for individually significant joint ventures or those that are publicly held. The ownership percentage should be given when separate financial statements of a joint venture enterprise are presented and, generally, should be disclosed as a range where there are numerous joint ventures with "immaterial" investment amounts in individual ones;

(c) Summarized information as to the venturer's proportionate share of all assets, liabilities, revenues and expenses of the jointly controlled entities - either individually or grouped;

(d) A venturer's portion of any contingent liabilities of the jointly controlled entities. Proper disclosure in the financial statements of a venturer should indicate the responsibility of the venturer for both its share of the contingent liabilities and also the other venturer's share of direct liabilities of the joint venture. At the same time it should be disclosed that the other venturer's share of assets would be available to satisfy the other party's share of direct liabilities;

(e) If a venturer guarantees more than its proportionate share of a joint venture's indebtedness, the nature and possible financial implications of such a guarantee should be disclosed.

B. Accounting for jointly controlled operations

52. In the case of jointly controlled operations, the participating venturers use their assets and other resources for the purpose of joint venture activity. Normally, no distinction is made between the assets and other resources used for the venturer's own activities and for the joint venture activity. There are usually no separate accounting records or financial statements for the jointly controlled operation, although the venturers may prepare memorandum accounts for management control purposes.

53. Since a venturer carries out its part of the jointly controlled operations just as it would have done for its own operations, each venturer retains in its accounting records and, hence, recognizes in its financial statements the assets that it controls. It also includes in its accounting records the liabilities and expenses that it incurs in respect of the jointly controlled operations and the revenue that it earns from the sale of its share of production. These liabilities, expenses and revenues are recognized along with the venturer's own liabilities, expenses and revenues in its financial statements.

54. If the involvement of a venturer in jointly controlled operations constitutes a significant part of its operations, that fact should be disclosed in the notes to the financial statements. The disclosure should include the financial implications of such involvements in terms of the volume of business activities. If any significant liability is incurred for undertaking the venturer's part of jointly controlled operations, that should be disclosed.

C. Accounting for jointly controlled assets

55. This type of joint venture is not a separate entity. Each venturer owns directly a specified share of the jointly controlled assets. This type of arrangement is often described as an undivided interest. Each venturer includes in its accounting records its own share of the jointly controlled assets. It also records liabilities that it has incurred in raising finance for the purpose of the joint venture activity and its share of those liabilities that it has incurred or guaranteed jointly with other venturers. Each venturer recognizes these assets and liabilities by combining these items with those of its own in its balance sheet. This treatment reflects both the substance and the legal form of the joint venture arrangement. The participating venturers own the assets directly and are responsible for the liabilities of the joint venture, rather than holding an interest in a separate entity.

56. The products of this type of joint venture are usually divided among the participating venturers in accordance with an agreed proportion. A venturer is at liberty to dispose of its share of the products in any manner it wishes. Each

venturer includes in its accounting records and, hence, recognizes in its income statement revenues from the sale of its share of the joint venture's products, together with its share of the expenses incurred by the joint venture. If a venturer incurs any expenses in financing its interest in the joint venture and for selling its share of the joint venture's products, they are recognized in the venturer's financial statements.

57. It is preferable to disclose in the notes to the venturer's financial statements the aggregate carrying amounts of each category of assets and liabilities that are dedicated to the activities of jointly controlled assets. Also, the venturer should disclose its share of any contingent liabilities of the joint venture. The responsibility of the venturer, if any, for the other venturer's share of contingent or direct liabilities should also be disclosed.

V. POSSIBLE CONCLUSIONS

58. After examining the analysis presented above, the Group may wish to draw the following conclusions:

A. Definitions

59. A joint venture may be defined as an arrangement whereby two or more venturers (parties) enter into a contractual agreement to control jointly a specific business undertaking and contribute resources to accomplish agreed-upon goals. The business undertaking may be a single project or a business enterprise. A joint venture implies that control is shared, with no one of the venturers in a position to exercise unilateral control over the financial and operating policies of the venture. The joint control of the participating venturers derives from a written legal agreement. Control does not necessarily have to be related to the proportion of capital contributed by each of the venturers. This element of joint control distinguishes a joint venture from other forms of long-term investment where control of decisions is related to the proportion of voting interest held.

60. A joint venture may take any legal form - e.g., partnership, trust, corporation etc. For the purpose of joint venture accounting, consideration needs to be given to substance over form. Joint ventures can be described as belonging to one of the following three types:

(a) Jointly controlled entities. Separate legal entities, they may be corporations, partnerships or any other forms of organization. The entity, in its name, owns the assets of the joint venture, incurs liabilities and expenses, and earns revenues;

(b) Jointly controlled operations. In these situations no separate entity is formed. Instead, parts of the venturers' existing enterprises work on a common project and co-ordinate their activities. The distinctive feature of this type of joint venture is that the assets and expertise assigned by each venturer for the joint venture activity remain in the ownership and under the control of the venturer that assigns them;

(c) Jointly controlled assets. Although no separate entity is created, the resources contributed by the participating venturers are pooled together for the purpose of a joint venture project which is managed either by one managing venturer or by a joint management team, typically known as the operator. Each venturer possesses an undivided interest in these assets. An example of jointly controlled assets is two or more oil exploration companies that enter into a joint venture agreement to own and operate jointly an oil pipeline.

B. Accounting by joint ventures in the case of jointly controlled entities

61. If the jointly controlled entity is an unincorporated entity, its financial reporting procedure should be similar to the financial reporting of a business partnership. Accordingly, the financial statements of an unincorporated jointly controlled entity should include a "Statement of venturers' capital", showing each venturer's capital account balance at the beginning of the accounting year, plus venturer's share of the net income for the year, plus (if any) new capital contribution by the venturer during the year, and minus any withdrawal by the venturer during the year. The ending balance of each venturer's capital account shown in the statement of venturers' capital should be reported against each venturer's name in the "venturer's capital section" of the balance sheet.

62. If the jointly controlled entity is an incorporated one - i.e., a corporation - its financial reporting and accounting disclosures should follow the conventional or legal requirements on corporate accounting in the country of operation. However, the jointly controlled corporate entity should prepare its financial statements in accordance with international practices such as are contained in Conclusions on Accounting and Reporting by Transnational Corporations. 2/

C. Accounting by joint ventures in the case of jointly controlled operations

63. The joint venture activities of a jointly controlled operation are delegated to the participating venturers, and each venturer carries out its part of the activities using its own resources. In this type of joint venture, no separate joint accounts of the jointly controlled operations are prepared. Therefore, the question of accounting by joint ventures does not arise. Each venturer maintains accounting records for its part of a jointly controlled operation.

D. Accounting by joint ventures in case of jointly controlled assets

64. These joint ventures normally maintain separate accounting records of the expenses incurred for the jointly controlled assets and the resources received from and the outputs delivered to the joint venture participants. These accounting records are maintained by the operator of the jointly controlled assets. The joint

venture agreement includes an accounting agreement which lays down procedures for reporting back to the venturers.

65. If the operator is one of the venturers and some of its own resources are used for joint venture activity there may be some problems in charging expenditures to the joint venture. There is no problem with direct expenditures, so long as the operator's accounting system can clearly identify the costs of a particular joint venture. Problems may arise over the amount to be charged to the joint venture for the services of facilities and staff of a large operator involved in many activities. It is up to the participating venturers to come to an equitable arrangement. However, an underlying principle in a cost sharing arrangement should be that the operator neither loses nor gains by virtue of acting in that capacity.

E. Accounting for jointly controlled entities

66. The basic issue in accounting for investments in jointly controlled entities relates to the choice of method of reporting the investments in the financial statements of participating venturers. The choice of method determines the amounts reported for the investment in the balance sheet and the manner in which operating results from the investment is reported in the income statement. The legal form of a jointly controlled entity should not govern the choice of method. For tax and various other considerations a jointly controlled entity may be either incorporated or unincorporated, but the substance of the joint venture arrangement will be same. Therefore, the methods discussed below are applicable to both incorporated and unincorporated forms of jointly controlled entities.

1. Proportionate consolidation method

67. Under the proportionate consolidation method, an investor consolidates in its financial statements its proportionate share of each asset, liability, revenue, and expense item of an investee. This method provides information in a venturer's financial statements on past and prospective changes in the economic resources and obligations of a venturer that is useful to present and potential stockholders and creditors. It reflects significant economic relationships between the venturer and the jointly controlled entity, such as complementary or integrated operations and obligations through direct or indirect guarantee or support agreement. It recognizes that a part of the assets, liabilities and operations of a joint venture enterprise is under control of a venturer (joint control is the most important characteristic of a joint venture arrangement).

68. Since a joint venture agreement establishes joint control of the participating venturers, proportionate consolidation of a jointly controlled entity's accounts in a venturer's financial statements would merely be an extension of the practice of including the accounts of all controlled entities, with related as well as unrelated lines of business, in the venturer's consolidated financial statements. The use of proportionate consolidation method would result in consistent accounting for all business activities in which a venturer is directly involved, regardless of the form of organization used to conduct such activities.

69. In many countries, in order to meet legal or other requirements, a venturer may need to present separate financial statements in addition to any consolidated financial statements. In its separate financial statements, a venturer may account for its interest in a jointly controlled entity either using proportionate consolidation or by using the equity method.

70. When a venturer sells an asset to the joint venture, it recognizes profits only to the extent that they relate to the interests of other venturers or when the joint venture sells the assets to an independent third party. A venturer recognizes losses resulting from sale of assets to the joint venture in the same way as profits, except that they are recognized immediately when they represent a permanent decline in the carrying amount of assets. When a venturer purchases assets from the joint venture, it recognizes its share of the profits of the joint venture only when it sells the assets to an independent third party. A venturer recognizes losses resulting from the purchase of assets from the joint venture in the same way as profits except that they are recognized immediately when they represent a permanent decline in the carrying amount of assets.

2. Disclosure requirements

71. In order for the users of financial statements to obtain a clear understanding of its affairs, a venturer needs to make adequate disclosures in its financial statements regarding its interests in joint venture enterprises. In addition to the application of proportionate consolidation for interests in jointly controlled entities, a venturer should make separate note disclosures in the financial statements showing the extent of its involvements in the assets, liabilities and operations of jointly controlled entities. The disclosures that should be considered relative to jointly controlled entities are as follows:

(a) Accounting policies of the venturer with respect to the investments in jointly controlled entities;

(b) Name of the joint venture and percentage of ownership interest of the venturer. Normally, the name of the joint venture and the percentage owned would be given only for individually significant joint ventures or those that are publicly held. The ownership percentage should be given when separate financial statements of a joint venture enterprise are presented and, generally, should be disclosed as a range where there are numerous joint ventures with "immaterial" investment amounts in individual ones;

(c) If ownership interests in any jointly controlled entities differ from the proportion of voting power held and the jointly controlled entities are significant ones, that fact should be disclosed;

(d) Summarized information as to the venturer's proportionate share of all assets, liabilities, revenues and expenses of the jointly controlled entities - either individually or grouped;

(e) A venturer's portion of any contingent liabilities of the jointly controlled entities. Proper disclosure in the financial statements of a venturer should indicate the responsibility of the venturer for both its share of the contingent liabilities and also the other venturer's share of direct liabilities of the joint venture. At the same time it should be disclosed that the other venturer's share of assets would be available to satisfy the other party's share of direct liabilities;

(f) If a venturer guarantees more than its proportionate share of a joint venture's indebtedness, the nature and possible financial implications of such a guarantee should be disclosed.

F. Accounting for jointly controlled operations

72. Since a venturer carries out its part of the jointly controlled operations just as it would have done for its own operations, each venturer retains in its accounting records and, hence, recognizes in its financial statements the assets that it controls. It also includes in its accounting records the liabilities and expenses that it incurs in respect of the jointly controlled operations and the revenue that it earns from the sale of its share of production. These liabilities, expenses and revenues are recognized along with the venturer's own liabilities, expenses and revenues in its financial statements.

73. If the involvement of a venturer in jointly controlled operations constitutes a significant part of its operations, that fact should be disclosed in notes to the financial statements. The disclosure should include the financial implications of such involvements in terms of the volume of business activities. If any significant liability is incurred for undertaking the venturer's part of jointly controlled operations, that should be disclosed.

G. Accounting for jointly controlled assets

74. This type of joint venture is not a separate entity. Each venturer owns directly a specified share of the jointly controlled assets. This type of arrangement is often described as an undivided interest. Each venturer includes in its accounting records its own share of the jointly controlled assets. It also records liabilities that it has incurred in raising finance for the purpose of the joint venture activity and its share of those liabilities that it has incurred or guaranteed jointly with other venturers. Each venturer recognizes these assets and liabilities by combining these items with those of its own in its balance sheet. This treatment reflects both the substance and, the legal form of the joint venture arrangement. The participating venturers own the assets directly and are responsible for the liabilities of the joint venture, rather than holding an interest in a separate entity. The income statement of a venturer includes revenue from the sale of its share of the joint venture's products. If the joint venture earns any revenue, and a venturer receives its share of that revenue, it is recognized as the venturer's other revenues.

75. It is preferable to disclose in the notes to the venturer's financial statements the aggregate carrying amounts of each category of assets and liabilities that are dedicated to the activities of jointly controlled assets. Also, the venturer should disclose its share of any contingent liabilities of the joint venture. The responsibility of the venturer, if any, for the other venturer's share of contingent or direct liabilities should also be disclosed.

Notes

1/ Florence E. De Roover, "Partnership accounts in twelfth century Genoa (1941)", Studies in the History of Accounting, A. C. Littleton and B. S. Yamey, eds. (London, Sweet and Maxwell, 1956).

2/ Conclusions on Accounting and Reporting by Transnational Corporations, United Nations publication, Sales No. E.88.II.A.18.

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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON THE INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING AND REPORTING ISSUES IDENTIFIED DURING THE SEVENTH SESSION

Accounting for intangible assets

Report of the Secretary-General

SUMMARY

In the 1980s, the significance of intangible assets (including goodwill, brands, patents, trade marks, research and development costs, software etc.) relative to the tangible assets of transnational corporations grew, often to a dramatic extent. A number of major factors are responsible, including the continuing wave of international mergers, the pursuit of global market leadership, the world-wide expansion of the services sector, the speed and extent of technological change, and the growing sophistication and integration of international financial markets. The accounting treatment of intangibles poses many problems which have yet to be resolved. In particular, criteria relating to the recognition of assets and the reliability of measurement are often subject to

* E/C.10/AC.3/1990/1.

different priorities and interpretations, resulting in a variety of applications. Since substantial judgement is involved in accounting for intangible assets, it is not surprising that a variety of methods are used. Appropriate accounting methods consistent with the objectives and concepts underlying financial statements should be selected. As a first step, consideration should be given to developing guidelines to resolve certain key issues surrounding intangible assets, such as recognition, separability and the use of prudence in evaluating the reliability of measurement.

Until further research is undertaken and guidelines developed, only tentative conclusions can be reached about this highly controversial subject. Consequently, the present report should be viewed as a basis for discussion rather than as a definitive statement.

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INTRODUCTION

1. The present report was prepared in order to provide the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting with a review of issues and practices relating to accounting for intangible assets. 1/

2. The accounting treatment of intangibles, including goodwill, brands, trade marks, patents, research and development, computer software and so on, poses many problems which have yet to be resolved. In particular, criteria relating to the recognition of assets and the reliability of measurement are often subject to different priorities and interpretations, resulting in a variety of applications in practice. Accounting for intangibles has become a topic of growing importance in the 1980s, and it is likely to become one of the major issues of the 1990s, requiring the attention of standard setters internationally.

3. The present report endeavours to analyse the issues involved, discuss the advantages and disadvantages of alternative methods of accounting for intangibles in the context of objectives and concepts underlying financial statements, outline current national practices on a comparative basis, and note any relevant international standards.

4. Section I presents a summary of findings. Section II reviews the objectives and concepts underlying financial statements in relation to the problems of accounting for intangibles. Sections III, IV, V and VI deal with major categories of intangibles - i.e., goodwill; brands, trade marks, patents and similar intangibles; research and development expenditures; and computer software.

I. SUMMARY OF FINDINGS

A. Significance of accounting for intangible assets

5. In the 1980s, the significance of intangible assets relative to the tangible assets of transnational corporations grew, often to a dramatic extent. A number of major factors are responsible, including the continuing wave of international mergers, the pursuit of global market leadership - often through the development or acquisition of famous brand names, the world-wide expansion of the services sector, the speed and extent of technological change - with special reference to the impact of information technology, and the growing sophistication and integration of international financial markets. 2/

6. As a result, the problems of accounting for intangibles, have been highlighted. Many of those problems have yet to be resolved, both in theory and practice, and there is currently a variety of accounting treatments that are considered acceptable.

7. Accounting for intangibles is likely to be a topic of major and growing importance in the 1990s. It is suggested that a substantial effort is now required in terms of research, experimentation, and consultation among all parties concerned

internationally to resolve some of the most difficult problems facing accountants in practice. Research and experimentation are likely to promote a better understanding of the nature of practice, the reasons underlying the choice of particular valuation methods and disclosures, and the feasibility of new approaches. Wide-ranging consultation is also necessary if agreement is to be reached on an appropriate regulatory framework relating to intangible assets.

B. Accounting for intangible assets: objectives and concepts

8. A statement of the objectives and concepts underlying financial statements is useful in providing a basis for evaluating alternative methods of accounting for intangible assets, and the recent papers on the subject by the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting provide authoritative guidance. 3/

9. It is accepted that the objective of financial statements is to provide useful information to a wide range of users for decision-making purposes and to keep management accountable for the resources entrusted to them. The information should be relevant, reliable, comparable and understandable.

10. The purpose of the balance sheet is to provide an indication of the financial strength of a company in a way that should help users to judge the ability of the company to meet its obligations.

11. A key concept governing the reporting of assets in the balance sheet is that of "recognition", which requires not only the expectation of future economic benefits but also the measurement of the assets with sufficient reliability having regard to the need to exercise prudence in judging the uncertainty of future outcomes.

12. Since intangible assets lack physical substance, an important criterion influencing recognition is whether they can be identified as separable resources which can be used to help a company meet its obligations. At the same time, the question of reliable measurement becomes more judgemental and problematic than in the case of tangible assets.

C. Accounting guidelines for the treatment of intangible assets

13. Since substantial judgement is involved in accounting for intangible assets, it is not surprising that a variety of methods are considered acceptable in practice. It is suggested, therefore, that consideration should be given to developing guidelines concerning the "recognition", and especially "separability", of intangible assets, together with the degree to which "prudence" is to be exercised in making judgements as to the "reliability" of asset measurement in this context.

14. In the light of user needs for "relevant" information, it is suggested that consideration should also be given to the extent to which balance sheets should report "current values" instead of, or in addition to, the "costs" of intangible assets.

15. In any event, it is suggested that consideration should be given to requiring that the disclosure of information about the accounting treatment of intangible assets be sufficiently detailed to permit users to make their own assessments of the treatment adopted and to evaluate the impact of alternative treatments. This disclosure approach would be consistent with evidence from research on capital markets which suggests that investors can make adjustments for accounting differences, provided that sufficient information is disclosed. Furthermore, users are more likely to be concerned with the content of the information disclosed than its form of presentation. The principle of full disclosure, or "transparency", is a principle to which all user groups are likely to subscribe and from which they will benefit in a situation where the flexibility of choice of accounting methods may be confusing and/or misleading.

D. Recognition and measurement of intangible assets

16. Given the controversial nature of the issues involved and the current state of knowledge, it is very difficult to find acceptable solutions at the present time. Thus, the principle of full disclosure or "transparency" becomes of paramount importance.

1. Accounting for goodwill

17. Accounting for goodwill continues to be a major issue of growing significance and controversy, with a variety of treatments in evidence across countries. Depending upon the accounting requirements concerned, companies may be able to capitalize goodwill as an asset with or without amortization or to write it off directly against equity. While capitalization without amortization is a minority practice, many countries adopt a flexible approach and permit either capitalization with systematic amortization or immediate write-off against equity. In practice, a majority of companies treat goodwill as an asset subject to systematic amortization. Only in a small number of countries is a maximum period of amortization specified, the norm being to require amortization over the useful economic life of the asset (see table 1).

18. Given the criterion of "separability", goodwill would not seem to qualify as an asset. Since goodwill is the difference between the value of a business taken as a whole and its individual assets and liabilities, it cannot be unbundled and identified as a separable asset. On the other hand, the measurement of purchased goodwill can be carried out with a reasonable degree of certainty. Further, since goodwill is a cost incurred with the expectation of future economic benefits, it does appear to meet the "reliability" criterion for asset recognition. However, it is much more difficult to meet that criterion when deciding on an appropriate period of amortization.

19. Pending further research and the development of guidelines concerning the implementation of these concepts, it is suggested that consideration should be given to requiring capitalization as an asset subject to systematic amortization.

Table 1. Comparative national practices of accounting for goodwill

Country or area	Asset with amortization	Maximum amortization period	Immediate write-off against equity permitted
Australia	Yes	20 years	Yes
Brazil	Yes	Not specified	Yes
Canada	Yes	40 years	No
France	Yes	Not specified	Yes, in exceptional cases
Federal Republic of Germany	Yes	Not specified	Yes
Hong Kong	Yes	Not specified	Yes
India	Yes	Not specified	Yes
Indonesia	Yes	Not specified	Yes
Italy	Yes	Not specified	Yes
Japan	Yes	5 years	No
Malaysia	Yes	Not specified	Yes
Mexico	Yes	Not specified	Yes
Netherlands	Yes	10 years	Yes
Nigeria	Yes	Not specified	Yes
Sweden	Yes	10 years	Yes
Switzerland	Yes	Not specified	Yes
United Kingdom of Great Britain and Northern Ireland	Yes	Not specified	Yes
United States of America	Yes	40 years	No

20. It is also suggested that consideration should be given to including goodwill adjustments in a separate statement of total gains and losses incorporating other equity adjustments, such as asset revaluations, foreign currency translation adjustments and so on.

2. Accounting for brands, trade marks, patents and similar intangibles

21. Accounting for brands, trade marks, patents and similar intangible assets is currently a highly controversial issue, with a variety of treatments in evidence across countries. Depending upon the accounting requirements concerned, companies may be able to capitalize such intangibles as assets with or without amortization or to write them off against equity. Problems associated with the treatment of these kinds of intangibles would seem to be closely linked to the goodwill issue. The capitalization of brand names has become an issue, particularly in countries where there is a more flexible approach to accounting practice in general, and especially where the amounts are large enough to have a serious impact on either earnings or equity. So far as the accounting treatment of brands is concerned, the majority practice is to capitalize them as assets without amortization - including, in some cases, home-grown brands - but subject to revaluation on a periodic basis, as appropriate. Trade marks, patents and similar intangibles tend to be treated as assets, subject to systematic amortization but are retained permanently as assets. A minority of companies adopt the method of immediate write-off against equity.

22. Given the criterion of "separability", brand names - especially those purchased - may well qualify as assets. Much will depend on the circumstances of each case to determine whether or not brands can be unbundled from their associated tangible assets and the business as a whole. As regards the "reliability" of measurement, there are many problems involved in making an assessment, since the value of goodwill usually includes the value of brands. While there is an expectation of future economic benefits, there are a number of alternative approaches to the valuation of brands which may be considered acceptable at the present time. Thus there is considerable debate as to whether brands can be measured with a reasonable degree of certainty. While the cost of trade marks, patents and so on can be assessed, it is also a matter of debate as to whether users would benefit more from information about measures based on "values" rather than costs.

23. Pending further research and the development of guidelines concerning the implementation of these concepts, it is suggested that consideration should be given to permitting "separable" brands, trade marks, patents and similar intangibles, including those developed internally, to be capitalized as assets. Alternatively, such assets could be systematically amortized over their useful lives as appropriate. In some countries periodic revaluation is allowed. Given the variety of valuation methods available, it is suggested that comprehensive information should be given as to the method used, the basis for revaluations, if any, and the basis for the amortization period adopted, where applicable.

3. Accounting for research and development expenditures

24. Accounting for research and development expenditures has become an issue of increasing importance, given the significance of such expenditures in many industries. A variety of treatments are in evidence across countries and, depending upon the accounting requirements concerned, companies may be able to write off research and development expenditures immediately against earnings or to capitalize them as assets subject to systematic amortization, according to the nature of the expenditure concerned. While the immediate write-off method is widely accepted, there are varying degrees of recognition across countries of the alternative method of capitalizing research and development expenditures subject to systematic amortization. A significant number of countries permit capitalization with amortization only in the case of development costs and where the technical feasibility and commercial and financial viability of the development project can be assessed with a reasonable degree of certainty. In only a small number of countries is a maximum period of amortization specified. In practice, however, only a minority of companies capitalize development costs.

25. Given the criterion of "separability", research and development expenditure would not seem to qualify as an asset, except in cases where development projects are sufficiently advanced so as to produce assets such as brands, trade marks, patents, or other assets which can be unbundled from their associated tangible assets and the business as a whole. On the other hand, at the development stage of a project it may be possible, irrespective of separability, to assess the future economic benefits of the costs incurred with a reasonable degree of certainty, thus appearing to satisfy the "reliability" criterion.

26. On previous occasions the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) agreed to the following:

> "The accounting policies to be followed with regard to research and development should have regard to fundamental accounting concepts, such as accrual and prudence. It is a corollary of those concepts that expenditure should be written off in the period in which it is incurred unless its relationship to the revenue of a future period can be established with reasonable certainty.
>
> It is recognized that research and development costs might be capitalized if all the following criteria were satisfied:
>
> (a) The product or process is clearly defined and the costs attributable to the product or process can be separately and clearly identified;
>
> (b) The technical feasibility of the product or process has been demonstrated;
>
> (c) There is a clear indication of a future market for the product or process or, if it was to be used internally rather than sold, its usefulness to the enterprise can be demonstrated;

(d) The management of the enterprise has indicated its intention to produce and market, or use, the product or process;

(e) Adequate resources exist, or are reasonably expected to be available, to complete the project and market or use the product or process." 3/

27. Pending further research and the development of guidelines concerning the implementation of these concepts, it is suggested that the current conclusions of the Working Group, which permit research and development expenditures to be capitalized subject to a project's technical feasibility and commercial and financial viability, be maintained. In such cases, systematic amortization would be required over the useful economic life of the project.

4. Accounting for computer software

28. Accounting for computer software is a relatively new issue, growing in significance along with the impact of information technology. Many of the problems involved are similar to those relating to research and development expenditure. There is a variety of accounting treatments in evidence across countries and, depending upon the accounting requirements concerned, companies may be able to write off software expenditures immediately against earnings or to capitalize them as assets subject to systematic amortization, according to the circumstances involved. While practice concerning the treatment of computer software is not well developed, there is a tendency to follow that of accounting for research and development. The majority practice is to write off software costs immediately, irrespective of whether or not the software has been purchased or internally developed. In a small number of countries, software costs may be capitalized as assets, but only in circumstances similar to development projects in the context of accounting for research and development expenditures.

29. Given the criterion of "separability", software costs would not seem to qualify as assets except in cases where the technical feasibility and commercial viability of internally developed software have been established. Where software is developed for use internally, its commercial viability externally would need to be established. As regards purchased software, much would depend on whether the software was customized, with restricted alternative use, or standard. On the other hand, it may be possible to assess the expectation of future economic benefits of the software costs incurred with a reasonable degree of certainty. Thus the "reliability" criterion relating to the measurements involved may well be satisfied, irrespective of "separability".

30. Pending further research and the development of guidelines concerning the implementation of these concepts, it is suggested that consideration should be given to permitting computer software costs to be capitalized with systematic amortization only in the case of internally developed software where technical feasibility and commercial viability have been established, irrespective of whether the software is to be used internally or sold externally. A similar treatment could be permitted in respect of purchased software with amortization required over the useful economic life of the software concerned.

II. ACCOUNTING FOR INTANGIBLE ASSETS: OBJECTIVES AND CONCEPTS

31. Issues concerning the objectives and concepts underlying financial statements have been addressed and conclusions drawn by the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting, as summarized below. 4/

32. It is accepted that the objective of financial statements is to provide useful information to a wide range of users, including present and potential investors, lenders, suppliers and customers, employees, Governments, the public at large and also those who act on behalf of users. 5/

33. The information provided should be useful to a wide range of users for decision-making purposes and should help to keep management accountable for the resources entrusted to them. 6/

34. The key characteristics of useful information are that it must be relevant to the needs of users and reliable to the extent that it reflects the events that it purports to represent and is free from material error and bias. 7/ Other important characteristics of useful information include comparability and understandability. 8/

35. An important element of reliability is the recognition that it may be necessary to exercise prudence in judging the uncertainties of future outcomes. 9/

36. Financial statements that are comparable across countries should be easier to understand. Thus, the harmonization of national standards or the adoption of international standards is desirable. 10/

37. It is recognized, however, that there may be conflicts in the application of these characteristics, depending on user needs and priorities. In resolving such conflicts, reference should be made to the balance between costs and benefits, the size of the reporting entity and the need for enterprises to maintain business confidentiality so as not to jeopardize their competitive position. 11/

38. The balance sheet shows resources or assets and claims and "provides an indication of the financial strength of the enterprise" which should help users "in judging the ability of the enterprise to meet its obligations". 12/

39. A key concept governing the reporting of assets in financial statements is that of "recognition", which requires not only that resources controlled by the enterprise from which future economic benefits are expected exist but also that the assets "can be measured with sufficient reliability and the amount involved can be reasonably estimated". 13/ It is emphasized that it is not enough for an item of expenditure to be incurred. "The expenditure must be followed by a reasonable expectation of future economic benefit. If such a degree of certainty does not exist, the expenditure is treated as an expense, not an asset." 14/

40. It is recognized that other important concepts include "going concern" and "accrual accounting". 15/

41. Intangible assets are deemed to include "purchased goodwill, patents, trade marks and similar intangibles". 16/ However, it is recognized that in a number of countries items such as patents, trade marks and so on may be recognized only if acquired for valuable consideration. 17/

42. Since intangible assets lack physical substance, their recognition as assets in financial statements would seem to depend heavily on the extent to which such assets can be identified as separable resources and the extent to which their expected future economic benefits can be assessed with reasonable certainty. It is evident that the interpretation of these concepts and their implementation in the case of specific issues, such as accounting for goodwill, brands, trade marks, patents, research and development, computer software and so on, will require considerable judgement, especially when concepts may conflict or when only some may be satisfied, but not others.

III. ACCOUNTING FOR GOODWILL

43. The dramatic growth of transnational mergers and acquisitions in the 1980s has highlighted the significance of goodwill and the problem of how to account for it. 18/ Goodwill in this context is the excess of the purchase price over the fair value of the net assets acquired by the bidding company. This is commonly referred to as "purchased goodwill" and is, in effect, a premium paid to cover the future earning capacity of the acquisition. Another way of looking at goodwill is to define it as the difference between the value of a company or business taken as a whole and the value of its individual assets and liabilities.

44. It is currently a matter of considerable controversy whether goodwill should be treated as an asset and, if so, whether or not it should be amortized against future earnings. 19/ This is an important issue, because earnings are perceived to be a significant indicator of business performance by a wide range of users. Moreover, there is likely to be a strong incentive on the part of management to show a favourable earnings result.

45. In practice, a variety of approaches is evident across countries and, depending upon the accounting requirements concerned, companies may be able to write off the cost of goodwill directly against equity or to capitalize it as an asset with or without amortization. 20/

A. Alternative accounting methods

1. Permanent retention as an asset

46. Proponents of this method argue that purchased goodwill should be capitalized on the grounds that future economic benefits are expected for which valuable consideration has been given and that in a successful business goodwill does not decline, because it is continuously maintained. Thus there is no need to amortize goodwill against earnings. Goodwill is also part of the cost of the investment and to amortize it against the earnings from the investment is to confuse the

measurement of earnings with that of capital. Where revaluations of goodwill are necessary, they should be adjusted against equity.

47. Opponents argue, on the other hand, that it is inconsistent to treat purchased goodwill as an asset but not to do so in the case of internally generated goodwill. Further, purchased goodwill should not be retained as an asset, because such goodwill is being continuously replaced by goodwill generated internally since acquisition. It is also argued that the recoverability of purchased goodwill has a high degree of uncertainty, even more than that of research and development expenditures, in that goodwill relates to the future of the company as a whole.

2. Asset with systematic amortization

48. While proponents of this method view purchased goodwill as an asset embodying future economic benefits for which consideration has been given, they believe that goodwill is a cost of resources which should be systematically amortized against earnings. Consistent with the "accrual accounting" concept, it is argued that costs should be matched against revenues. Goodwill is viewed as similar to other assets that are consumed or used up in the production of future earnings. If goodwill is not amortized, then future earnings would be overstated, since there would be a failure to include all costs incurred to generate such earnings. Further, where any permanent diminution in value occurs, the effect of any such revaluation should be charged against earnings immediately.

49. Opponents of this method argue that double-counting occurs because both expenditures to replace declining purchased goodwill with internally generated goodwill are made at the same time as the amortization of purchased goodwill. Further, it is very difficult to estimate when the goodwill will be exhausted, and hence the period of amortization will be arbitrary, with a consequent arbitrary and potentially severe impact on earnings.

3. Immediate write-off

50. Proponents of this method argue that purchased goodwill is not an asset for the purposes of financial statements. Goodwill is not separable or independently realizable but exists only by virtue of a valuation of the company or business as a whole. It is not a resource consumed or used up, similar to other production resources. Further, the true value of goodwill has no predictable relationship to the costs paid on acquisition, as its value will fluctuate over time, according to a variety of economic factors and changes in investor opinion. Comparability between firms is also enhanced in that neither purchased nor internally generated goodwill are recognized as assets. Accordingly, goodwill is written off against equity - i.e., realized or unrealized reserves - with no charges made against earnings. Alternatively, the write-off can be shown as a separate negative amount or "dangling debit" in the financial statements, which in effect reduces the equity amount. A variant of this approach is to write off goodwill immediately against earnings, usually as an extraordinary or non-recurring item.

51. Opponents of this method argue that purchased goodwill is indeed an asset embodying expected future benefits and should be treated as such, either with or without amortization. Further, there are likely to be problems with writing off large amounts of goodwill, especially in the case of service companies (with limited tangible assets) and highly acquisitive companies, such that equity may become depleted or even negative and leverage unduly high.

B. Comparative national practices

52. A variety of approaches to accounting for goodwill is evident across countries. 21/ In a survey of 18 countries from different parts of the world (see table 1), it seems clear that most countries adopt a fairly flexible approach, with companies permitted either to treat goodwill as an asset subject to systematic amortization or to write it off immediately against equity. Only in a minority of countries is goodwill permitted to be capitalized without amortization.

53. Where the amortization treatment is adopted, a maximum period of amortization is stated in only a minority of cases. The maximum ranges from five years in Japan to 10 years in the Netherlands and Sweden, 20 years in Australia, and 40 years in Canada and the United States of America. Most countries specify only that amortization should be based on the criterion of "useful economic life". In practice, companies adopt a variety of amortization periods to suit their circumstances.

54. Where an arbitrary period is stated, it is not necessarily the period used in practice. In Japan, the majority of companies write off goodwill on consolidation against earnings immediately, although it should be noted that these amounts tend to be small, owing to the relatively few subsidiaries consolidated in accordance with the requirements. In the United States of America, majority practice is to use a 5-10 year amortization period, although many large companies use up to 40 years, especially those making large acquisitions. It is interesting to note a number of transnational corporations based, for example, in the Federal Republic of Germany, Italy, Sweden, and Switzerland, adopting a 40-year amortization period consistent with the required maximum in the United States of America.

55. Only in Canada, Japan and Mexico is the method of immediate write-off against equity not permitted, similar to the United States of America. On the other hand, European practice, along with that of many other countries or areas including Brazil, Hong Kong, India, Indonesia, Malaysia, and Nigeria, tends to be more flexible. Prior to the European Community's Seventh Directive on Consolidated Accounts, it was common practice in France and the Federal Republic of Germany for goodwill, arising from consolidation, to be permanently retained as an asset in the balance sheet. With the recent implementation of the Seventh Directive in most of the European Community countries, the practice has been, or is in the process of being, eliminated. 22/ Companies now have a choice between the systematic amortization of goodwill against earnings over a period not exceeding the useful economic life of the asset or its immediate write-off against equity. In the United Kingdom, the immediate write-off method has in fact become the preferred method in practice, mainly because of its favourable effect on reported future earnings. This approach has been criticized by United States companies on the

grounds that United Kingdom companies have a competitive advantage in making takeover bids internationally in that they escape the burden of goodwill amortization against future earnings required in the United States of America. 23/ However, with the dramatic growth of merger activity, the amounts written off against equity have now become so large that many companies in the United Kingdom have become concerned about the perceived effect on the strength of the balance sheet and the degree of leverage. This would seem to have motivated some companies, especially in the services sector, where the treatment of goodwill has had the most impact, to review their policy towards intangibles and to decide to treat brands, together with trade marks, patents, licences, copyrights, publishing rights and so on, as assets for balance-sheet purposes. It is noteworthy that in Australia the current trends relating to the treatment of goodwill and other intangibles have been very similar to those in the United Kingdom, where there are similar accounting traditions.

C. International accounting standards

56. The International Accounting Standards Committee (IASC) has undertaken to promote harmonization. International Accounting Standard No. 22, "Accounting for business combinations", deals with goodwill but recommends a flexible approach - i.e., either to capitalize goodwill as an asset and amortize it over its useful economic life or to adopt immediate write-off of goodwill against equity. 24/ No maximum period of amortization is recommended.

57. More recently, however, IASC has embarked on a project to improve the comparability of accounts across countries with a number of proposals on comparability of financial statements (E32), including the treatment of goodwill. 25/ IASC proposals, published in January 1989, are to eliminate the immediate write-off method and to adopt the required treatment of recognizing goodwill as an asset to be systematically amortized against earnings over its useful economic life. However, the proposals go further than that, to require a maximum period of amortization of five years unless a longer period can be justified - not, in any case, to exceed 20 years. These proposals seem destined to be controversial in the light of current theoretical debate and flexibility of practice operational in many countries.

IV. ACCOUNTING FOR BRANDS, TRADE MARKS, PATENTS AND SIMILAR INTANGIBLES

58. The pursuit of "globalization" by many transnational corporations in the 1980s has become associated with the acquisition of famous brand names, trade marks, patents, licences, franchises, publishing titles and so on, as a means of rapidly obtaining market share especially in the services sector. 2/ The purchase price of acquired brands is commonly included in the payment of goodwill. Thus the accounting treatment of brands and similar intangibles is closely associated with issues arising in the context of goodwill.

59. The identification of brand accounting as an issue has arisen from the recent

practice in some countries, notably Australia and the United Kingdom, of putting a separate valuation on acquired brands and including them as assets in the balance sheet. 26/ While this is controversial enough, there have also been instances of home-grown as well as acquired brands being capitalized. Entity as well as product brand names have also been capitalized.

60. It has been suggested that a major reason for capitalizing brands is the result of the controversy over goodwill and, in particular, the practice of immediate write-off which normally has the consequence of depleting shareholders' equity. 27/ Another reason is that companies are perceived to have been undervalued by the stock market through not explicitly recognizing the value of their brands. In practice, a wide variety of approaches to accounting for brands and similar intangibles is evident with companies in some countries able to capitalize brands as assets with or without amortization. 28/

A. Alternative accounting methods

1. Permanent retention as an asset

61. Proponents of this method argue that acquired brands and similar intangibles should be capitalized on the grounds that future economic benefits are expected for which valuable consideration has been given and that the value of brands does not decline, because it is continuously maintained through advertising expenditures and so on. Thus there is no need to amortize brands against earnings. Brands are separable intangible assets which can be valued. It is recognized, however, that there may be instances where amortization is appropriate or unanticipated write-offs in value occur and would need to be recognized. The principle of capitalizing brands can also be extended to home-grown brands on the grounds of consistency, comprehensiveness and comparability.

62. Opponents argue, however, that while brands are valuable assets, it is not possible to assess the expected future economic benefits with a reasonable degree of certainty. Furthermore, it is considered very difficult to identify and assess the value of a brand as a separable asset. Although a brand may have legally separable property rights attached, such as trade marks, patents and designs, they are not themselves the entire brands but only a part of it. There are also a variety of alternative valuation methods which could be used - including the historical cost-based approach, market valuation, current cost, the allocation of cost of goodwill, discounted cash flow and the earnings multiple approach - all of which involve varying degrees of subjective judgement.

2. Asset with systematic amortization

63. Proponents of this method argue that, while acquired brands may be viewed as assets embodying future economic benefits, they are a cost incurred which will be used up in generating future earnings. Such costs should be systematically amortized against earnings consistent with the "accrual accounting" concept.

64. Opponents argue that the value of brands is continuously maintained by advertising expenditure and other means, and that amortization is, therefore, inappropriate unless there is evidence to the contrary. If amortization is appropriate, then it should be over the useful economic life of the asset - not over an arbitrary period.

3. Immediate write-off

65. The immediate write-off approach is supported by the argument that brands and similar intangibles are not assets for balance-sheet purposes because they are not separable from other associated assets, tangible or human, nor independently realizable. Further, it is not possible to assess the future economic benefits of brands with a reasonable degree of certainty. It is argued, therefore, that "prudence" should govern the "recognition" decision. Accordingly, the cost of brands should be written off immediately against equity or earnings consistent with the treatment of goodwill. This treatment would also enhance comparability between firms.

66. Opponents of this method argue that brands are indeed assets and should be recognized as such with or without amortization. A valuation approach is desirable because it is more relevant to users in providing information about the substance of the business.

B. Comparative national practices

67. While many countries recognize the cost of acquired trade marks, patents, and similar intangibles as assets, the issue of accounting for "brands" is relatively new and controversial. 29/ This has arisen from the recent practice by some large transnational corporations in Australia and the United Kingdom of identifying brands as intangible assets. In Australia, it has been accepted practice to value licences, copyrights and publishing rights for some time now with a similar practice being followed more recently in the United Kingdom. However, it was only in 1988 that a significant number of companies in the United Kingdom, including Ranks Hovis McDougall, Grand Metropolitan, Guinness and United Biscuits, decided to incorporate brand valuations in their balance sheets, thus restoring or creating substantial amounts of equity. 30/ While most companies have valued only recently acquired brands, usually on the basis of allocating an appropriate proportion of the cost of goodwill, there have been companies such as Ranks Hovis McDougall that have valued both home-grown and acquired brands. The valuation approach used here was apparently "current cost", based and permitted by company law. Moreover, it was stated that the cost of brands would not be systematically amortized but would be reviewed annually. A problem with this valuation approach, along with others, is that the companies concerned have provided very little information about the valuation process, thus making the valuations very difficult to interpret. On the other hand, international firms of auditors have accepted these brand valuations for balance-sheet reporting purposes.

68. The Accounting Standards Committee in the United Kingdom, which has so far issued only a provisional point of view on the issue, has discouraged companies

from incorporating valuations in balance sheets in the absence of a generally accepted method of valuation and uncertainty as to the reliability of the information. 31/

69. In Australia, the Australian Accounting Research Foundation, in Exposure Draft 49 (August 1989), proposed that all acquired, identifiable intangible assets should be recognized as assets and stated at their cost of acquisition. Home-grown brands would also qualify for recognition. The systematic amortization approach is proposed for all intangible assets, based on useful economic life, although it is suggested that 20 years would be expected to be the maximum. Periodic revaluation of the assets would also be required. All valuations would be carried out by an independent professional expert.

70. While accounting for brands does not yet appear to have become an issue elsewhere, the treatment of intangibles such as trade marks, patents, licences and so on is on the whole a flexible one. In continental Europe, for example, the tendency in practice is for such items to be recognized as assets and then systematically amortized over their useful economic lives. On the other hand, many companies write off intangibles against equity. In the European Community countries, the Fourth Directive on Company Accounts states that intangible assets, including internally developed assets, may be recognized in the balance sheet but must be systematically amortized over their useful economic lives or written down to reflect any reductions in value. 32/ Under the alternative valuation rules (article 33), it appears that a "current cost" valuation of intangible assets is permitted by the Fourth Directive as an alternative to acquisition cost.

71. In the United States of America, the identifiable intangible assets such as trade marks, patents, licences, copyrights and so on are recognized as assets and treated similarly to goodwill - i.e., amortized over their estimated useful lives up to a maximum period of 40 years. Internally developed intangibles, on the other hand, must be written off immediately against earnings.

C. International accounting standards

72. The problems of accounting for brands, trade marks, patents, licences and so on have not been dealt with as yet by an international accounting standard.

V. ACCOUNTING FOR RESEARCH AND DEVELOPMENT EXPENDITURES

73. Technological change, with special reference to information technology, has been a dramatic feature of the 1980s with transnational corporations playing a major role in new developments. 2/ The significance of research and development expenditures in the overall business context has increased.

74. Research and development expenditures include direct and indirect costs related to the creation and development of new processes, techniques, applications and products. It has been suggested that three categories of expenditure can be identified:

(a) Pure research, which is directed primarily towards the advancement of knowledge in general and not towards any specific practical aim or application;

(b) Applied research, which is directed primarily towards exploiting the knowledge obtained in pure research and to applying it in an area of business interest; and

(c) Development, which is work directed towards the introduction or improvement of specific products or processes. 33/

75. A variety of expenditures can be classified under the heading of research and development, including expenditures on tangible fixed assets, which would be subject to the usual requirements relating to such assets, personnel costs, materials and services, relevant overhead costs and the amortization of patents and licences.

76. Market research and advertising may also be considered under research and development expenditure, and treated accordingly.

77. In practice, a variety of approaches is evident across countries and, depending upon the accounting requirements concerned, companies may write off research and development expenditures immediately against earnings or be able to capitalize them as assets, subject to systematic amortization, according to the nature of the expenditure involved. 34/

A. Alternative accounting methods

1. Asset with systematic amortization

78. Proponents of this method argue that research and development expenditures should be capitalized and amortized on the grounds that such expenditures are incurred with the expectation of producing future economic benefits and that the "accrual accounting" concept should, therefore, be applied. Accordingly, expenditures should be capitalized and systematically amortized against earnings in future periods. To treat research and development expenditures as immediate write-offs against earnings would produce a distorted view of income for the period and an unrealistic view of assets in the balance sheet. Moreover, the immediate write-off of expenditures may inhibit companies from undertaking research and development in the first place.

79. Opponents argue, however, that the future economic benefits of research and development expenditures are too uncertain to warrant "recognition" as assets.

2. Immediate write-off

80. Proponents of the immediate write-off approach argue that research and development expenditures are not assets, because it is not possible to assess the future economic benefits of such expenditure with a reasonable degree of certainty. Accordingly, the "prudence" concept should prevail over the "accrual

accounting" concept for the purposes of financial statements. Further, any attempt to match expenditures and benefits is an arbitrary process because there is no supportable basis upon which to carry it out. If no economic benefits are forthcoming in reality from the expenditures incurred, then the financial stability of companies may be at risk. There is also the possibility that earnings results could be manipulated through the amortization process.

81. Opponents of this method argue that research and development expenditures should be treated as assets, because they embody future economic benefits, and that users would be better informed by recognizing such expenditures as assets. It is often argued that, at the very least, certain types of development expenditures should be capitalized and amortized against future earnings. This would be justifiable where the technical feasibility and ultimate commerical viability of the development project would be assessed with reasonable certainty.

B. Comparative national practices

82. A variety of approaches to accounting for research and development is evident across countries. 35/ In a survey of 18 countries from different parts of the world (see table 2), it seems clear that the tendency is for the majority of countries to adopt a relatively prudent approach to asset recognition and the assessment of expected future economic benefits. While the immediate write-off method is widely accepted, there are varying degrees of acceptance of the alternative method of capitalizing and amortizing research and development expenditures.

83. The most prudent approach would seem to be found in the Federal Republic of Germany, Mexico and the United States of America, where all costs are written off immediately against earnings, unless, of course, tangible assets with alternative uses are involved, such assets being amortized against earnings in the usual way. In many other countries, including Canada, France, Malaysia, Nigeria, Switzerland and the United Kingdom, all research costs must be written off immediately, but development costs may be capitalized in certain specified circumstances and amortized to match the future revenues generated by the asset. The usual criteria include the technical feasibility and commercial and financial viability of the development project, all of which would need to be assessed with a reasonable degree of certainty for the development expenditure to be carried as an asset. Such expenditure is also permitted to be carried forward where a company has been contracted to carry out work for which it is to be reimbursed. In practice, only a minority of companies capitalize development costs.

84. A small number of countries, including Italy, Japan, the Netherlands and Sweden, permit the capitalization of research and development expenditure, but they require such amounts to be amortized within a maximum period of five years, although the Netherlands permits a ten-year amortization period in certain circumstances. In the Netherlands it is also necessary to establish a reserve to match the research and development amounts capitalized. It is pertinent to note here that the European Community's Fourth Directive on Company Accounts indicates a maximum amortization period of five years.

Table 2. Comparative national practices of accounting for research and development

Country or area	Asset with amortization	Maximum amortization period	Immediate write-off against earnings
Australia	Yes	Not specified	Yes
Brazil	Yes	10 years	Yes
Canada	No a/	Not applicable	Yes
France	No a/	5 years or longer, if justified	Yes
Federal Republic of Germany	No	Not applicable	Yes
Hong Kong	Yes	Not specified	Yes
India	Yes	Not specified	Yes
Indonesia	Yes	Not specified	Yes
Italy	Yes	5 years	Yes
Japan	Yes	5 years	Yes
Malaysia	No a/	Not applicable	Yes
Mexico	No	Not specified	Yes
Netherlands	Yes b/	5 or 10 years	Yes
Nigeria	No a/	Not applicable	Yes
Sweden	Yes	5 years	Yes
Switzerland	No a/	Not specified	Yes
United Kingdom of Great Britain and Northern Ireland	No a/	Not specified	Yes
United States of America	No c/	Not specified	Yes

a/ Exceptions permitted in specified circumstances in the case of development costs only.

b/ A reserve must be established if research and development are capitalized.

c/ Exceptions permitted in specified circumstances in the case of computer software development costs.

85. In some countries, or areas such as Australia, Brazil, Hong Kong, India and Indonesia, there would seem to be a flexible approach to the treatment of research and development expenditures in that there is a lack of regulation on the issue, and various methods are practised.

C. International accounting standards

86. The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting considered accounting for research and development in 1985. It agreed not only what costs should be disclosed but also how such costs should be accounted for - that is, whether they should be expensed or capitalized. 3/

87. The following cost elements associated with research and development activities should be disclosed:

(a) Salaries, wages and other related costs of personnel engaged in research and development activities;

(b) Costs of materials and services consumed in research and development activities;

(c) Depreciation of equipment and facilities to the extent that they were used for research and development activities;

(d) Overhead costs related to research and development activities;

(e) Other costs related to research and development activities, such as the amortization of patents and licences.

88. The accounting policies to be followed with regard to research and development should have regard to fundamental accounting concepts, such as accrual and prudence. It is a corollary of those concepts that expenditure should be written off in the period in which it is incurred, unless its relationship to the revenue of a future period can be established with reasonable certainty.

89. It is recognized that research and development costs might be capitalized if all the following criteria were satisfied:

(a) The product or process is clearly defined and the costs attributable to the product or process can be separately and clearly identified;

(b) The technical feasibility of the product or process has been demonstrated;

(c) There is a clear indication of a future market for the product or process or, if it was to be used internally rather than sold, its usefulness to the enterprise can be demonstrated;

(d) The management of the enterprise has indicated its intention to produce and market, or use, the product or process;

(e) Adequate resources exist, or are reasonably expected to be available, to complete the project and market or use the product or process.

90. The following disclosures should be made in regard to research and development activities:

(a) The accounting policies adopted as regards research and development costs;

(b) Research and development costs charged as an expense for the current period, as a specific item;

(c) The basis used to amortize deferred research and development costs;

(d) The movements of the unamortized deferred research and development costs, including:

(i) The total amount of research and development costs incurred during the current period, as a specific item;

(ii) Research and development costs of the current period deferred for amortization over future periods;

(iii) The amount of deferred research and development costs amortized and charged to expense for the current period;

(iv) The balance in the account of the unamortized deferred research and development costs at the end of the period;

(e) If research and development costs were allocated to subsidiaries and affiliates, the basis for such allocation;

(f) An indication of activities in the field of research and development during the reporting period.

91. International Accounting Standards No. 9 deals with accounting for research and development activities and recommends the immediate write-off against earnings of research and development expenditures. 36/ However, there is an exception in the case of the development costs of a project which satisfy specified criteria, including the technical feasibility of the project, the separable identification of the costs involved, the existence of a future market or internal usefulness, if it is to be used by the enterprise itself, the existence of adequate resources to develop the product and the expectation that the costs can be recovered from future revenues from the project. Disclosure of the total amount of research and development expenditures, including the amortization of deferred costs, is also required by the standard.

92. More recently, IASC has proposed in its exposure draft "Comparability of financial statements" (E32), published in January 1989, that the preferred treatment of research and development expenditures should be to adopt the immediate write-off method. 25/ This recommendation is based on the view that asset

recognition in this context becomes very uncertain and that the majority of companies appear to accept such an approach. At the same time, IASC also proposes the capitalization of development costs as an allowed alternative treatment be permitted, provided that there is a reconciliation with the immediate write-off method.

VI. ACCOUNTING FOR COMPUTER SOFTWARE

93. Arising from the dramatic development of information technology in the 1980s has been the rapid growth in the development and use of computer software. 2/ There has been considerable controversy as to how to account for software, especially in high-technology companies. This issue is closely associated with the treatment of research and development expenditures, especially insofar as internally developed software - compared to purchased software - is concerned. Further issues concern the distinction between standard and custom software and whether or not the software is for own-use or for sale. To the extent that copyrights or patents are involved, with software, the accounting issues will be similar to those for identifiable, intangible assets. 37/

94. In practice, a variety of approaches is evident across countries and companies. Depending upon the accounting requirements concerned, companies may be able to write-off software expenditures immediately against earnings or to capitalize them as assets subject to systematic amortization, according to the circumstances involved. 38/

A. Alternative accounting methods

1. Asset with systematic amortization

95. Proponents of this method argue that acquired software which embodies expected future economic benefits should be treated as an asset and systematically amortized against earnings in future periods. Thus the "accrual accounting" concept would be applied. In the case of internally developed software the same criteria for "recognition" would apply but in order for there to be reasonable certainty about the future benefits involved it would be necessary for the technical feasibility and value of the software to be established.

96. Opponents argue, however, that the uncertainty of future economic benefits does not warrant the "recognition" of software as assets in any event. Accordingly, the "prudence" concept should prevail over the accrual accounting concept for financial statement purposes.

2. Immediate write-off

97. The immediate write-off treatment is preferred by those who argue that the degree of uncertainty of future economic benefits is unacceptable and that software should not, therefore, be treated as an asset. Further, any attempt to match cost

against benefits is arbitrary with no supportable basis for allocation. Accordingly, all expenditure associated with software, whether home-grown or acquired would be written off immediately against earnings.

98. Opponents of this method argue, however, that the immediate write-off approach distorts earnings to the extent that high technology companies may be inhibited from investing in software development. Despite the arbitrariness of the "accrual accounting" process users will benefit from information which is more relevant to the economic substance of the business.

B. Comparative national practices

99. Accounting practice concerning the treatment of computer software is not well developed and there are few regulations but in most countries there is a tendency to follow that of accounting for research and development. 39/ It would seem that any assessment of the future economic benefits associated with software development costs is a very uncertain process. As a result, software costs are usually immediately written off against earnings. In some countries, however, it may be possible to capitalize software costs, but only in exceptional and strictly specified circumstances.

100. In the United States of America, software costs incurred before technological feasibility is established must be charged against earnings immediately in accordance with Financial Accounting Standard No. 86. 40/ Costs incurred subsequent to the establishment of technological feasibility may be capitalized but must then be systematically amortized against the revenues generated. Furthermore, the capitalization of software costs must cease when the product is available for general release to customers. In the case of purchased software, capitalization with amortization is permitted but only when the software has an alternative future use. In Sweden and Switzerland, where this issue has also been considered, there tends to be a more flexible approach to asset identification in that software development costs may be capitalized where future economic benefits are expected though in practice companies usually adopt the immediate write-off method.

101. In France, both internally developed and purchased software must be capitalized as soon as they are used in the company's operations. Purchased software is permitted to be written off against earnings within one year, whereas internally developed software should be amortized over its useful economic life. In the Federal Republic of Germany, purchased software must be similarly capitalized and systematically amortized over its useful economic life. In Japan, purchased software may be capitalized but must be amortized over a five-year period whereas internally developed software is treated as a research and development expenditure and accounted for accordingly.

102. In Australia and the United Kingdom there are no specific requirements relating to software developed internally and practice is based on their approach to research and development expenditures. Purchased software tends to be written off immediately against earnings.

C. International accounting standards

103. The problems of accounting for computer software have not yet been dealt with by any international accounting standard.

Notes

1/ See E/C.10/1989/7.

2/ See Transnational Corporations in World Development: Trends and Prospects (United Nations publication, Sales No. E.88.II.A.7).

3/ Conclusions on Accounting and Reporting by Transnational Corporations (United Nations publication, Sales No. E.88.II.A.18).

4/ Objectives and Concepts Underlying Financial Statements (United Nations publication, Sales No. E.89.II.A.18).

5/ Ibid., para. 24.

6/ Ibid., para 23.

7/ Ibid., paras. 8-17.

8/ Ibid., paras. 18-23.

9/ Ibid., para. 16.

10/ Ibid., para. 23.

11/ Ibid., paras. 26-28.

12/ Ibid., para. 45.

13/ Ibid., para. 32.

14/ Ibid., para. 52.

15/ Ibid., para. 53.

16/ Ibid., para. 33.

17/ Ibid., para. 50.

18/ The Process of Transnationalization and Transnational Mergers (United Nations publication, Sales No. E.89.II.A.4).

Notes (continued)

19/ See, for example, P. A. Taylor, Consolidated Financial Statements (New York, Harper and Row, 1987); Belverd E. Needles, Jr., Financial Accounting (New York, Houghton Mifflin, 1989).

20/ See, for example, Spicer and Oppenheim International, Guide to Financial Statements Around the World (New York, John Wiley, 1989); D. J. Tonkin, ed., World Survey of Published Accounts (London, Lafferty Publications, 1989).

21/ See Spicer and Oppenheim, op. cit.

22/ European Community, Seventh Directive on Consolidated Accounts (Brussels, 1983).

23/ See, for example, United States General Accounting Office, Foreign Investment: Country Differences in Accounting for Takeover Costs (Washington, D.C., December 1987).

24/ International Accounting Standards Committee, IAS22. Accounting For Business Combinations (London, January 1989).

25/ Ibid., E32. Comparability of Financial Statements (London, January 1989).

26/ P. Barwise and others, Acccounting for Brands (London, London Business School and The Institute of Chartered Accountants in England and Wales, 1989).

27/ P. Rutteman, "Mergers, acquistions, brands and goodwill", Accountancy (September 1989).

28/ Barwise and others, op. cit.

29/ Ibid.

30/ See, for example, S. J. Gray, "Accounting for brands: a mission impossible?" The Investment Analyst (April 1989).

31/ Accounting Standards Committee (of the United Kingdom of Great Britain and Northern Ireland), Provisional Views on Accounting for Intangible Assets, with Special Reference to Brands. Technical Release No. 738 (London, January 1989).

32/ European Community, Fourth Directive on Co-ordination of National Legislation Regarding the Annual Accounts of Limited Liability Companies (Brussels, 1978).

33/ See, for example, Needles, op. cit.; J. A. Samuels, C. Rickwood and A. Piper, Advanced Financial Accounting (New York, McGraw-Hill, 1989).

34/ See Spicer and Oppenheim, op. cit.

Notes (continued)

35/ Ibid.

36/ International Accounting Standards Committee, IAS9. Accounting for Research and Development Activities, (effective January 1980).

37/ See, for example, OECD Working Group on Accounting Standards, Accounting Treatment of Software (Paris, December 1986).

38/ Ibid.

39/ Samuels, Rickwood and Piper, op. cit.

40/ Financial Accounting Standards Board (of the United States of America), Statement of Financial Accounting Standards No. 86, Accounting for Costs of Computer Software to be Sold, Leased or Otherwise Marketed, (Washington, D.C., August 1985).